QRS Wealth Management LLC

Overview

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Observations

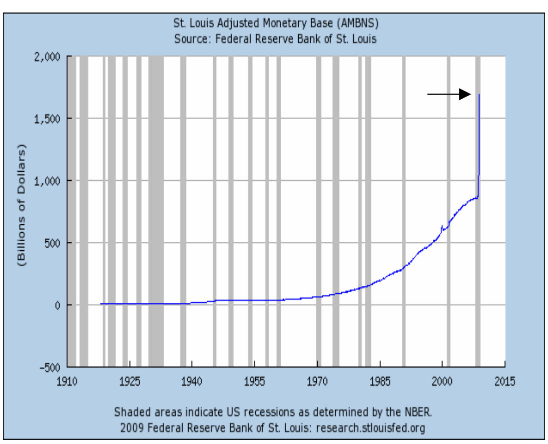
- The new Presidential administration and Congress are dealing with the same problems. What we are pondering, is government solving problems or are they making the problems worse? Are problems being solved or are only symptoms being treated? How do we encourage government to find the right solutions as opposed to political solutions?
- In the past decade, we have seen the bursting of bubbles in technology, real estate, commodities, and equity markets. We have seen massive fraud from Enron to Madoff. Our financial system is crippled by greed and regulators asleep at the wheel. In the short-term, investors are right to be skeptical until there is more evidence of a level playing field.
- Something has to give with the US dollar. Interest rates cannot sustain such a low rate for an extended period. The dollar will likely weaken and/or interest rates will rise. Stimulus spending by the federal government will work its way into the economy, which will eventually increase inflationary fears. Buckle up for what will likely be a wild ride.

Important Figures

Economic

US Government's Income Statement (CBO Outlook)

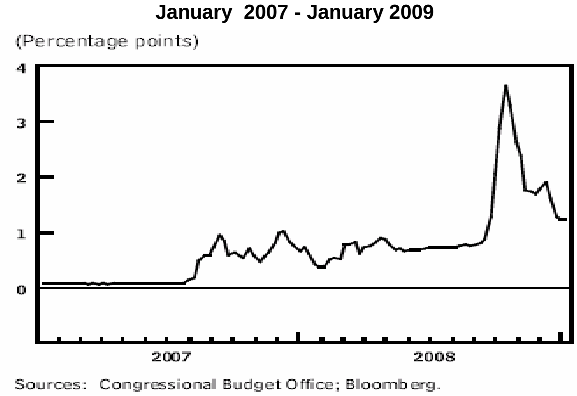
(in billions!)	2008(a)	2009(f)	2010(f)	2010-1019
Revenues	$2,524	$2,357	$2,533	$35,991
Outlays	$2,978	$3,543	$3,236	$39,126
Deficits	-$454	-$1,186	-$703	-$3,135
Federal Debt	$5,803	$7,193	$7,829	$9,344



Financial

	Treasury Yields		Equity Markets	
	5 Year	10 Year	S&P 500	DJWilshire 5000
2006	4.70%	4.71%	1,336	14,257
2007	3.45%	4.04%	1,468	14,819
2008	1.94%	2.96%	896	8,945
1/30/2009	1.85%	2.87%	826	8,336
YTD Return			-7.85%	-6.81%

The Risk Spread Between LIBOR and Fed Funds (3 Month)
January 2007 - January 2009



Economic Outlook

- "De-leverage" sounds much more official than "paying down debt". That bit about being responsible and living within one's means actually turns out to be true. The above table and chart should concern you. Interest must be paid on the debt. History has shown us that rapid money supply growth leads to worse things, like inflation and higher tax rates. Government spending today, especially pork, is jeopardizing the entire economic world.
- Household consumption is declining, including necessary items like food and healthcare. Economics 101 teaches us that people are smart. They will prioritize needs versus desires and look for substitutes that provide the same level of satisfaction. With consumer wages not likely to rise, the supply side (companies) are going to have to lower prices or provide better value in order to encourage demand. Deflation will bark but not bite in 2009.

Investment Outlook

- Make no mistake that the financial capital has shifted from Wall Street to Washington DC. Until the new administration and Congress provide a more certain direction, do not expect much from markets.
- Until the LIBOR - Fed Funds risk spread returns to normal, do not expect markets to behave in a rational manner. Abide the volatility.
- The banking sector despite all the federal money thrown at it just does not appear to be a compelling investment story. Having to pay dividends on preferred shares to Uncle Sam, will take a bite out of cash flow. Government backed debt is more appealing in the short term than equity of many financial firms.
- Equity investors should pay careful attention to the safety of dividends. Wise investors know the value of a portfolio of dividend paying firms.

Insightful Thoughts of Others

What I suspect is that policy makers — possibly without realizing it — are gearing up to attempt a bait-and-switch: a policy that looks like the cleanup of the savings and loans, but in practice amounts to making huge gifts to bank shareholders at taxpayer expense, disguised as "fair value" purchases of toxic assets.
- Paul Krugman on government attempts to stabilize banks

When a fellow says it ain't the money but the principle of the thing, it's the money. - Kim Hubbard

A Few More Things

- **What could go right.** There is no single catalyst that will fix this economic mess. Nobody will ring a bell when we hit bottom and not all the news is bad. There is still a great deal of cash on the sidelines waiting to be invested. People are working hard to fix problems. Years from now, those that performed careful analysis (and some who were just plain lucky) will have profited handsomely. Institutional and private shareholders will force reforms in corporate America. At best, government steps are a positive; at worst government gridlock could prevent further economic decline. Consumers and corporations with little or no debt will be fine and buffer the economic decline. Many have now learned the lessens of debt and will be reluctant borrow so heavily in the future. Better managed firms know how to survive in a difficult market environment. Entrepreneurship flourishes in times like these and should contribute mightily to the recovery. At some point, prices will have fallen enough to bring buyers back to markets and create a healthy demand.

- **The reality of the residential real estate problem** is that actions by government to forestall or "solve the crisis" are actually making things worse. Many homeowners in trouble have stopped making mortgage payments with the anticipation that government relief is coming. There are homeowners with negative equity or without income to make their mortgage payment with a mindset that it takes months to foreclose, so why not live in the house for free until forced to leave the property. After leaving a property, they will likely become renters. If property prices were allowed to adjust to market rates, there would be potential homeowners who could buy at new market prices thus clearing "bad loans" from the system. Investors will also be able to purchase distressed properties at reduced prices and rent them at what would likely be a lower rental price than a troubled homeowner's current mortgage payment (and property taxes).

- **Fear and Loathing in Congress as Social Security and Medicare** are the twin 800 pound gorillas in the room that still nobody wants to discuss. Give Clinton credit for the idea of setting aside budget surpluses of the late 1990s into a trust fund for Social Security. Give Bush credit for being willing to discuss privatizing the system and open to other ideas. The most common solutions discussed as to how to fix the problems are either a tax increase, cutting benefits, or some combination of the two. Would the government consider ending the programs by giving each American a check based on some calculation of present value of one's benefits based on life expectancy? Our forecast is for the combination of tax hikes and benefit reduction, plus an increase in the retirement age in order to start benefits. This will likely impact those born after 1960 and we could see the normal retirement age increase to 75 for those born after a certain date, say 1985 for example.

- **Why are banks being encouraged to lend so aggressively?** Isn't that how we got in this mess? Maybe if banks are properly regulated and not encouraged to take excessive risks, we can prevent the next economic meltdown. Regulatory failures should result in regulators being accountable to the American taxpayer by losing jobs and not just providing cover for Congress. One more thing, if a company applies for a bailout due to negligence, someone should be in handcuffs, an orange jumpsuit, and a significant reduction in the net worth of those responsible. You think you would then see government officials, bankers, and other executives stand-up and do the right thing?

- Happy 200th birthday President Abraham Lincoln. **Hope springs eternal** - baseball's spring training begins this month.